DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92037

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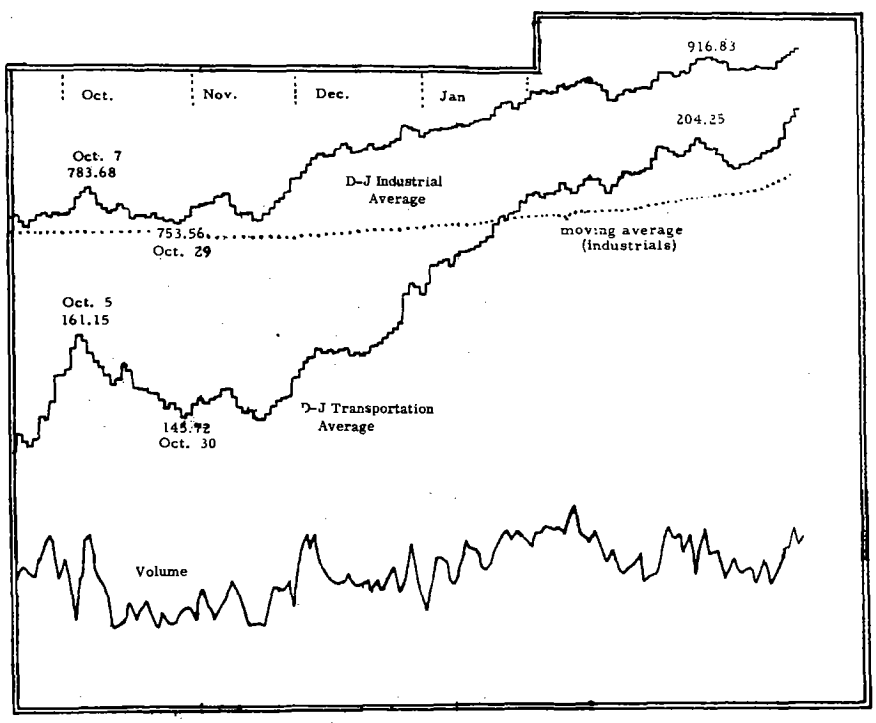
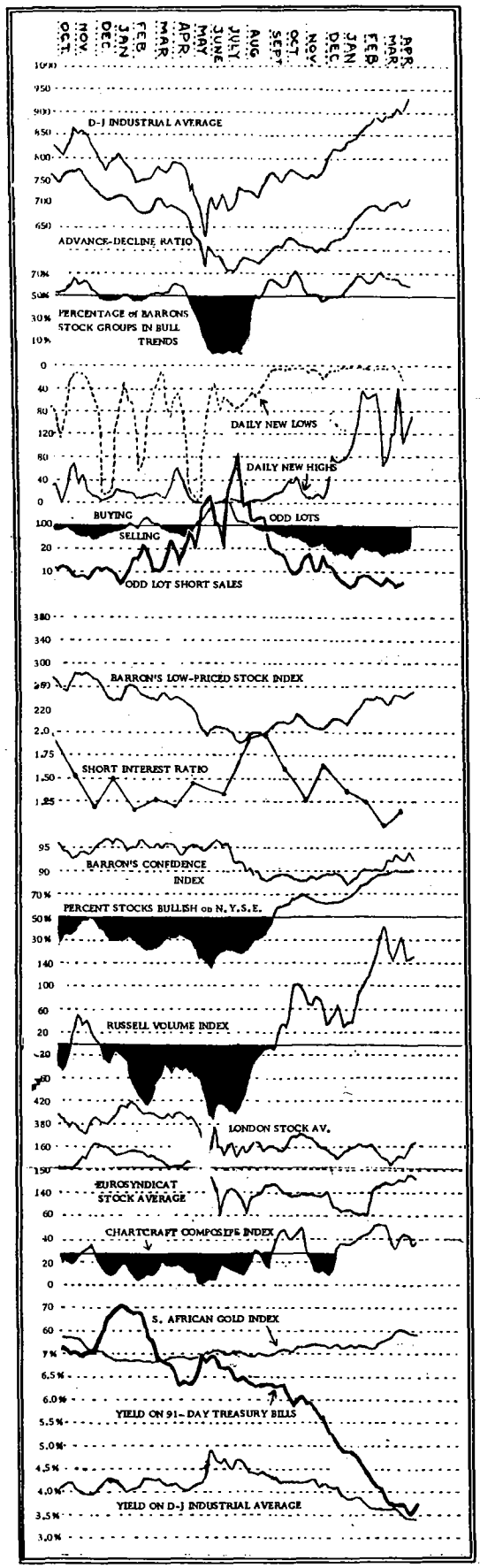
THE PICTURE: Almost every leading economist in the nation agrees on a single point: Americans are saving at a record rate because of lack of confidence, and business is playing it very close to the chest for the same reason—lack of confidence. No one can actually pinpoint the reasons for the lack of confidence. I have read article after article each offering its own explanations. The consumer is worried about unemployment the consumer is worried about the Administration's policy in Vietnam the consumer is worried about the quality of life inthe U.S., the consumer is worried about inflation and the Government's failure to halt it the consumer is worried about the "troubled feeling in the air", the perpetual crises which encompasses everything from the bankruptcy of the cities to the rocketing Federal deficits.

My own feeling is a bit different. I believe that we are entering a new age, an age in which many of the habits and customs of the 1950's and 1960's are changing drastically. I have a teen-age daughter who is a thinker and an actor, and our house is a platform for perpetual debate and discussion. And what I hear and see is different from yesterday. First of all the kids don't dress the same. T-shirts and blue jeans are standard dress. Motorcycles and little cars are the mode of transportation. Gone is the prestige of the big Buick or Chrysler convertible. Gone is the prestige of the $15 madras shirt. Gone is the prestige of the cruise to Europe with mom and dad. The kids want no part of these.

Yesterday I picked up a boy about 20 years of age who was hitchiking to the University of California at San Diego. "How do you think things are going around the country," I asked him by way of an opener. His answer shocked me.





Without a second's hesitation he snapped, "The country is falling apart." I was amazed and I said, "That's kind of a drastic statement isn't it. Is that what most of the students think?" He looked at me strangely, as if I were a creature from another planet. The look spoke what was on his mind. It was obviously, "Where have you been dad?" This generation, I thought, isn't fooling around. Do you want to know about confidence in America? Talk to the under - 25's and you'll see what happened to confidence. They lost it somewhere along the line, perhaps listening to their parents or reading the headlines in the daily newspaper.

When I got to the office I studied my chart of the Dow Jones Averages. I stared at the bull market top of 995.15 recorded in 1966, the second rebound top of 985.21 established in December, 1968, following the late 1966 collapse. I examined the current rally peak which follows the 1969-70 collapse. Suddenly the whole structure began to make sense to me. The country is changing the very unconscious and the living habits of the nation are changing and the market has been expressing it in terms of heart attacks (collapses) and semi-recoveries (rebounds). But the old order is dying and the old policies and ideas are not working, and the market is gasping, trying to hold itself together as long as it can. But in the end the purge will come, as the bear market wipes out the old, spills the dirty water for all to see, rips open the closet doors to expose the skeletons, and paves the way for perhaps a new and better kind of world.

For five years the old order has fought the bear. In the five years since the February, 1966 peak, much has happened but little has changed. The Vietnam war goes on, inflation continues, budget deficits are certain, the dollar grows weaker, and the Administration in power tells the American people what it feels is good for them to hear. The remedies are the same too. Monetization of the debt, tax cuts if the economy won't pick up, Government spending to spur the economy, new controls if the economic seam starts tearing, new manipulations if the dollar pile-up in Europe threatens to set off a panic.

The frightening thing about the stock market is that it can see farther ahead than any single man or group of men. It will go along with an Administration just so long, and then it speaks the truth. When the truth is harsh, when it flies in the face of what people want to believe, it is then that the market is performing its true barometric function. At present, the market is stirring hopes, and hopes are stirring the market. But behind the climb from the 1970 lows is the fact that the entire structure since 1966 is part of a long, extended, persistent bear market, a bear market that is saying that the winds of change are blowing.

For five years the stock market has been trying to measure the meaning of the coming storms and hurricanes of change. The Averages, in their swings from the 1966 high to the 1970 low, back towards the 1966 high again, are saying that "Things are not yet crumbling, yet conditions will not return to the euphoria of five years ago." Wall Street reflects not only reality but hopes, and all the speculation of 1971 cannot cover the grim facts, such as the one alluded to in this clip from last week's Wall Street Journal.

The history of this nation indicates that conditions never become prosperous—and then stay that way. On the contrary, history suggests the swings to extremes. Ever since 1966, the market has kept us alternately on our guard or hoping. And despite the desperate pleas and "brave words" of the politicians, the confidence of the 1960's, that elusive confidence, cannot seem to catch fire again.

I don't think it will. The questions keep getting bigger, the problems loom larger, the under-25 population keeps expanding, and they're not about to follow the path of their parents, nor would they want to if they could. Dow's Theory states that the cycle of human sentiment runs as far as it can in one direction, then it switches and runs as far as it can in the opposite direction. It may take another two years or another five years to reach the extremes of pessimism, but the sand is running out of the hour-glass and the winds of change are blowing at the edifice of the 1950's and '60's. It behooves us to batten down the hatches and prepare, each of us, to play our own part.

Factory Profit Margins Stayed at Nine-Year Low

By a WALL STREET JOURNAL *Staff Reporter*

WASHINGTON — Factory profit margins in the fourth quarter continued to run at a nine-year low, the government reported.

Manufacturers' after tax profits in the December quarter fell to 3.7 cents on each dollar of sales from 3.9 cents in the third quarter and were more sharply below the year-earlier period's 4.2 cents, said a joint report of the Federal Trade Commission and the Securities and Exchange Commission. This was the smallest profit margin since the 3.5 cents in the first quarter of 1961; the third quarter margin also was a nine-year low.

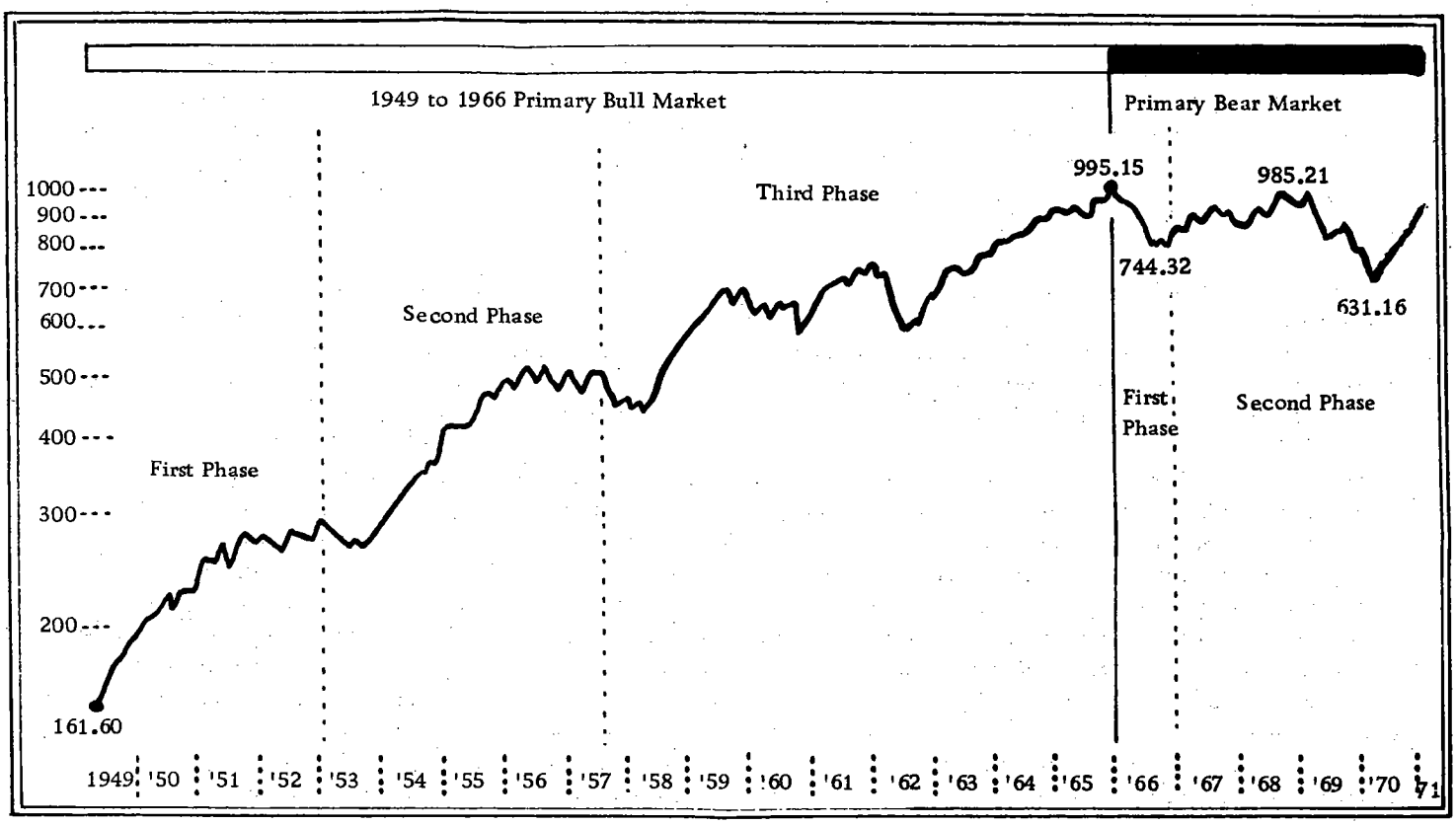
For all last year, the profit margin dropped to four cents from 4.8 cents in 1969, the report also said.

The annual rate of profit on stockholders' equity fell to 8.7% in the fourth quarter from 9% in the third and was much further below the 11.3% of the year-earlier quarter, the report said.

As far as the market is concerned, in all my studies of Wall Street I have never seen such a huge speculative edifice built on such froth. The facts of business are worse than they were at the 1970 lows, and even the promises ring false. It is obvious that the funds "have the ball" now, and the public, which is trying to cope with the very difficult financial realties of their daily lives, are tight-fisted in their buying habits and acting the same way regarding stocks.

Somewhere ahead (and I don't think it will be too far), I believe there is going to be a sudden and "unexpected" reversal (which will be falsely termed "the beginning of an intermediate correction"). That point will mark the start of the next major bear market decline. My guess is that the whole, uncorrected structure built since May, 1970, will then crumble as wave after wave of torrential selling brings people to the stark realization that this primary bear market is more alive than ever, and that the rise since '70 lows was nothing more than a tower of sand.

If there is a single major defect in the leadership of this nation I would say it is now arrogance. Arrogance has so far cost us $115 billion in Vietnam and the lives of 53,000 American soldiers, arrogance has cost us the loss of the major part of our gold reserves, arrogance has caused us to ignore the warnings of the Europeans regarding our monstrous deficits, and the same arrogance has been reflected in the Dow's fourth climb above 900 since 1965. Arrogance is not enough to hold this market up in 1971. When the speculative bubble bursts, the arrogance will turn to cold fear.



DOW THEORY: The Dow Theory actually comprises two separate themes, the three-phases (i.e., psychological phases) concept of all primary bull and primary bear markets, and the mechanical concept of the bull and the bear signal. The first theme is rather theoretical, and therefore much more difficult to understand and interpret. The second theme (comprising the price movement) is rather mechanical, and so easy to understand that in the minds of most people, this is the essence of the Theory.

This might be a good time to clarify the issue. Charles Dow actually made no reference to bull and bear "signals". Dow noted, however, that there were three movements in the market, at all times working together. These were the minor or daily movements. The minor movements existed within the context of the secondary movements, which were the larger trend and counter-trend movements, tending to last a few months or longer. And the secondary movements always operated within the context of the major or primary movement, lasting a few years or longer. Thus they may be conpared to the movements of the ocean, the main tidal movement, the waves or secondary movements, and the ripples on the waves or the minor movements.

Dow noted that there were cycles of prosperity and depression, and at all times the market and the economy was on the track of either the prosperity cycle or the depression cycle. "There is always a disposition in people's minds", wrote Dow, "to think that existing conditions will be permanent. When the market is down and dull, it is hard to make people believe that this is the prelude to a period of activity and advance. When prices are up and the country is

prosperous, it is always said that while preceding booms have not lasted, there are circumstances connected with this one which makes it unlike its predecessors and gives assurance of permanency. The one fact pertaining to all conditions is that they will change."

Now the above was written during far simpler days, when the laws of supply and demand were much more obvious than they are today. I have written extensively about today's Governmental manipulation, and the Government philosophy which states that almost anything is justified in order to insure prescribed levels of "prosperity". This type of thinking and acting was, more than anything else, responsible for the extension of the primary bull market from 1949 to 1966, a period of 17 years (making it the longest bull market in recorded history).

By the same token, the persistent Government "anti-recession" efforts since 1966, have served to stave off the full force of the current bear market, even though 1969-70 did see the worst stock market collapse since the mid-1930's. In these Letters I have been emphasizing the cyclical aspect of Dow's Theory, since this is the part that is most important. At the same time, I have de-emphasized the mechanical "bull signal" and "bear signal" part of the Theory, since this is the part which always gets the full attention; yet this is the aspect which is least significant at present.

William Hamilton and Robert Rhea added much to, and codified the Dow Theory. Rhea noted that there are three psychological phases in both bull markets and bear markets. During a bull market there is the first phase which is the rebound from the depressed levels of the preceding bear market. The second phase, often the most deceptive, is the long rise in the stock market, reflecting improving business conditions and expanding corporate profits. Finally, we have the third phase, which is the speculative phase, brought on by the eager, often frenzied, desires of the public to get in on the "new era" of perpetual prosperity.

By the same token, a bear market is usually subject to three psychological phases. The first phase is the decline which wipes out much of the froth of the previous bull market's final, speculative upthrust. The second phase, usually the most deceptive, is the decline reflecting deteriorating business conditions and receding corporate profits. The final phase of a bear market is the depression phase, brought on by hard times and the need to sell stocks and other negotiable articles for whatever the market will bear (in order that money be raised to meet current living needs).

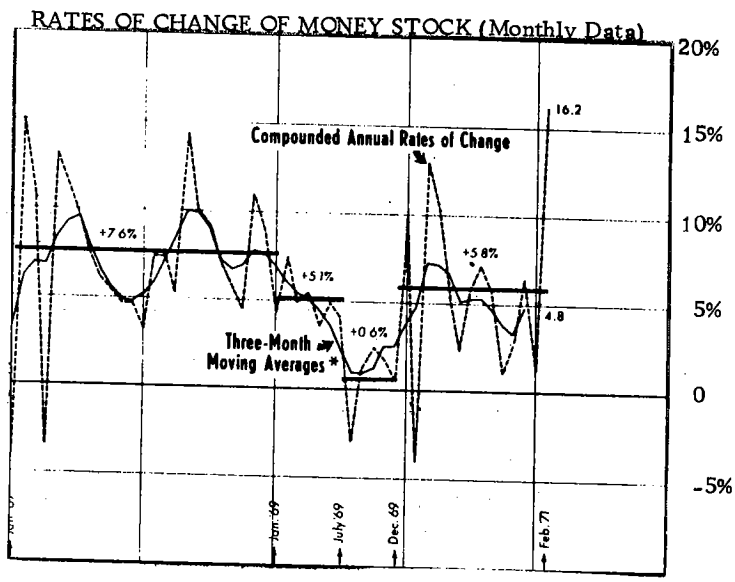
I have shown the bull market of 1949-66 and the bear market of 1966 to date, on the accompanying chart (page 3). From the standpoint of Dow's Theory and from the standpoint of the long-term investor, it is crucial to remember that the most important gauge of a bull market's imminent end is the identification of a true third phase. By the same token, the really important identification of a bear market's termination is the arrival of the third or final depression stage. It is during these third phases that the mechanical bull or bear signals come into prominence. For instance, once we know that the current bear market is deep into its third and final phase, we will probably start purchasing stocks regardless of what the Averages are doing. We will be buying on the basis of stocks selling at "great values", as exemplified by yields, price earnings ratios, depressed prices, etc. For instance, all market history tells us that when the Dow Industrials are yielding 6 - 10%, when price earnings ratio on the Dow are in the 6-9 range, when "nobody wants them" but they are great values as gauged by historically high yield and price-earnings ratios, when those conditions appear during a major and extended bear market which is obviously in its final phase — that is the time to buy and become 100% invested.

Now, this is the same period when the much-talked about "bull signal" becomes important. When third phase bear market conditions are present, when blue-chip stocks are selling at extraordinary values, when everyone is depressed and telling you that Wall Street will never again revive, the market's refutation to all that nonsense is the classic major upward zig-zag or bull signal (appearing in both the Industrial and Transportation Averages). That signal is a supply-demand equation.

The first extended rise off the market bottom could be simply a rally or it could be the first leg of the new bull market (which nobody believes will ever occur again). A downward movement (of a few weeks or more) follows, but one or both Averages hold above the bear market bottom. Then, a new upward leg begins as demand starts overcoming supply again. At that point where both Averages better their previous highs, the market will have signalled a reversal of the primary trend. Wall Street, in effect, has proclaimed a new bull market.

But note that the bull signal has come as a confirming device; it has confirmed all our previous hypotheses regarding the probable end of the bear market. We have already bought heavily on the basis of the length, the phases, the depth of the bear market and on the basis of stocks selling at great values. Judging from all these factors, we have good reason to believe that the primary bear market is over, and that the worst has already been discounted. To put it simply, when it can't get any worse it can only get better. And that is how a new primary bull market is born.

Referring again to the chart on page 3, note that the 1949-66 bull market was very unorthodox because each phase was longer than the preceding. Classically, the second phase of a bull market is the longest phase, and the third phase is rather short. But what happened, I believe, is that from the period of 1949 and ever since, the Government has steadily increased its manipulations. This had the effect of extending each phase of the primary trend. Actually, the third phase of the bull market probably "should have" ended around 1960 or perhaps 1962. But each time the Government stepped in with massive infusions of credit, and the result was an extension of the bull market until 1966.



The first phase of the bear market was concluded in 1966. The market broke suddenly, and the Dow lost 251 points before the Administration knew what had happened. During 1967-68 the Government poured money into the banking system, and the Dow recovered to within 10 points of its 1966 high. Then followed the crushing decline of 1969-70. In 1971 the Government opened the money spigots again, and as you can see from this chart from the Federal Reserve Board of St. Louis (March report), the rate of change of the money supply is now going through the roof.

So far, this type of action on the part of the Government (plus a steady barrage of bullish propaganda) has succeeded in taking the Dow back to 918, just 77 points from its 1966 bull market peak. I will not go into the massive deterioration which has accompanied the Government's manipulative efforts since 1966, but it is sufficient to say that with all the power of the Government, conditions today are much, much worse than was the case in 1966.

Meanwhile, the second phase of this bear market is extending, being dragged out, pushing into a five-year affair. Frankly, I don't know when the second phase will be over, but I do believe that because of everything which has happened during this second phase so far, we are going to experience one of the worst bear market wind-ups in history.

The fact is that almost every segment of the economy is now sick. Whether you're talking about the employment picture, the tax picture, the monetary front, profit margins, the bond market, the Government's finances or the cities' or the states' finances, the balance-of-payments, the budget deficits, the foreign competitive picture, the inflation picture, regardless of what area of the economy you point to the picture is one of problems and major troubles.

Thus this second phase of the bear market has seen a building of excesses and problems, even while Wall Street has provided a kind of smoke screen over the whole mess. However, I will make a prediction. Wall Street will also be the first to pierce the smoke screen. It will probably do so as the second phase goes into its final movement, plunging the Dow well below the 631.15 low of 1970. When that happens I expect the fog to lift and the problems to emerge. All this, I believe, will occur sometime during this year and in 1972. That will set the stage for the third and final phase of this bear market. During that final phase, we will probably be in a position to buy stocks at their lowest levels of the Century. And that is the way I see it. And patience will be the problem for every reader of these Letters. The problem for the rest of the country, I think will be fear, ignorance and greed.

COMMENT: In Letter 489 I commented on a few other services and publications. One was International Monetary Issues (P.O.B. 1313, Haifa, Israel) by Mr. Gabriel Alon. Mr. Alon is a very hard-working and knowledgable individual, and he appears to like my writing. My comment in Letter 489 brought Mr. Alon dozens of subscriptions, and it brought me a note asking me whether I had seen the new Lynatrace Report's comments on Dow Theory Letters. Mr. Alon stated that he wanted to include their comments in a forthcoming issue, and he asked me for my own answer. Actually, Lynatrace was very kind to me, although they do not agree with my bearishness and view of the situation.

The following (which I thought would interest readers) is my answer to Mr. Alon, and I presume it will appear in a forthcoming International Monetary Issue:

Dear Mr. Alon:

I do not usually get embroiled in arguments and debates regarding my work. My studies deal with the long-term trend of the market as identified by Dow's Theory. I have learned that the majority of investors generally go broke trading the minor and even intermediate trends of the market.

Let's face it. Most people do not make money on Wall Street. If they did, we would have many more millionaires in this country than we do. True, many people make money for a time, but ultimately Wall Street shears the public - due to no fault of Wall Street's, but due to the public's ignorance as to the ways of the market.

I try to teach people profitable investment procedures, while also teaching them a bit about the market and the economy. One of the basics in making money on the Street is to be fully invested during bull markets and fully liquid in bear markets (gold shares excepted).

This sounds easy; it is not. For the market can be very deceptive at times, and my job is to show the deception, to point it out to my readers. At times I stand practically alone (as now), but I am used to this. I have also been in this business for 14 years, which is a long time to survive in the investment service business. I have seen many "hot shot" services with new theories and techniques come and go during that 14 years. My motto has been, watch out for the genius who is fabulously "right" for a year or so; he is the one who will make the biggest blooper and be on his way out during the next few years.

You can't be a genius, calling every secondary turn on Wall Street. Most services don't call the major bull or bear markets correctly, and that's what puts them out of business. It will happen again, probably this year. I believe this great rally in a continuing bear market is fated to be one of the costliest deceptions in stock market history.

And I guess that's all I have to say, which, it seems to me, is quite a bit.

Incidentially, here are a few more publications which I like:

Kaffir Chart Service (Palisades Park, New Jersey 07650) is $49 per year. Charts all the S. African gold shares on a daily basis with a separate line for the ADR prices. Very handy for those who want to know what's happening to the S. African gold shares.

Market Indicators Digest (P.O. Box 23224, Johannesburg, S.Africa) by Fred Macaskill, who tells me that has modeled his service after Dow Theory Letters. I believe this is S. Africa's only technical service, and Fred does a very good job with it. He writes much about the gold picture, and, of course, he is very close to it.

The Janeway Service (15 E. 80th St., New York, N.Y. 10021) at $150 per year on a weekly basis. This is written by my illusion-smashing economist friend, Eliot Janeway. This famous economist will give you the low-down on what's happening in the economy, in Washington, in the corporate meeting rooms, and in the heads of the heads of corporations. Janeway sees things his own way, and his way is most often remarkably the right way. Fascinating and educational reading

Morgan Guarantee Survey (23 Wall St., New York, N.Y. 10015). Free for the asking, I find this monthly survey well worth reading. Morgan has much prestige, and what they think influences many investors and economists.

Cleveland Trust Business Bulletin (Cleveland, Ohio 44101). Everything said about Morgan applies to this Bulletin, and the price is the same — gratis.

Green's Commodity Market Comments (P.O. Box 174, Princeton, New Jersey 08540). Acute comments and discussions of gold, silver, and commodities with always interesting viewpoints. Mr. Stahl, the author, has been around a long time and personally went through the German inflation prior to Hitler. I don't always agree with him on the gold situation today, but I respect his opinion.

Holt Investment Advisory (305 Madison Ave., N.Y.C., N.Y. 10017) at $120 per year. A shrewd and helpful service that provides excellent information all round, and I particularly like their technical readings of N.Y.S.E. "insider" activity. They're bearish, but not to the extent that I am.